School of Law

Pace Law Review

Pace University *Year* 2009

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FLAWED ECONOMIC ASSUMPTIONS: CRITICAL PERSPECTIVES

Mortgage Market Reform and the Fallacy of Self-Correcting Markets

Robin Paul Malloy*

I. Introduction

Markets are the product of volitional arrangements that incentivize particular networks and patterns of exchange.[1] The

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1. *See* DANIEL W. BROMLEY, SUFFICIENT REASON: VOLITIONAL PRAGMATISM

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sustainability of any given set of market relationships, therefore, depends on the goals to be achieved and the appropriateness of the established incentive structure. These incentivized relationships are subject to numerous influences and dynamics requiring careful supervision, continuous re-evaluation, and regularized adjustments over time. In this context, the current crisis in U.S. housing and mortgage markets reflects poorly incentivized exchange relationships. The current situation cannot simply be blamed on meaningless metaphors related to being caught in "the perfect storm." The crisis in the United States, which also underlies the crisis globally, stems from an overly optimistic view of self-regulating markets and of the belief in an unregulated "invisible hand."[2]

AND THE MEANING OF ECONOMIC INSTITUTIONS (2006).

2. The reference here is to Adam Smith and his famous metaphor of the invisible hand. Adam Smith mentions the idea of the invisible hand in his work, *The Wealth of Nations* and also in his earlier work on *The Theory of Moral Sentiments*. Below are samples quotes from each book. With respect to the actions of a person following his own self-interest, Smith observed that:

> He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it. . . . [B]y directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always worse for society that it was no part of it. By pursuing his own interest he frequently promotes that of society more effectively than when he really intends to promote it.

1 ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 477-78 (Edwin Cannon, ed., Univ. of Chicago Press 1976) (1776).

> The rich only select from the heap what is most precious and agreeable. . . . [I]n spite of their natural selfishness and rapacity, though they mean only their own conveiniency, though the sole end which they propose from the labours of all the thousands, whom they employ, be the gratification of their own vain and insatiable desires, they divide with the poor the produce of all their improvements. They are led by an invisible hand to make nearly the same distribution of the necessaries of life, which would have been made, had the earth been divided into equal portions among all its inhabitants, and thus without intending it, without knowing it, advance the interest of the society . . . .

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It is not a storm caused by nature; it is the product of human action and inaction resulting from a lingering belief in laissez-faire.

The current situation calls for volitional and purposeful regulation of mortgage markets. Simply throwing money at banks, lenders, and defaulting borrowers is not enough.[3] There is a need to examine and reform current market operations. Significantly, it should be noted that the need for examination and reform is not the same as suggesting the elimination of secondary mortgage markets. In fact, we need secondary markets for mortgages and securitization to facilitate economic development, risk spreading, and enhanced liquidity.

This Article examines the mortgage market meltdown from the perspective of market exchange theory, or what I have elsewhere referred to as law and market economy.[4] From this perspective, I examine the exchange relationships among primary and secondary mortgage market participants in an effort to identify potential problems and to offer some suggestions for reform.

While there are many issues that might be addressed in considering all of the various elements of the U.S. mortgage

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ADAM SMITH, THE THEORY OF MORAL SENTIMENTS 304 (E.G. West, ed., Liberty Classics 1969) (1759).

3. We need structural change in the way in which we incentivize exchange relationships. While supportive funding may be important, it must be accompanied with action to change the way in which exchange is taking place. Reform is needed so as to improve current market operations. *See infra* discussion Part IV (suggesting specific steps that can be taken to positively change the current networks and patterns of exchange in the primary market).

4. *See* ROBIN PAUL MALLOY, LAW AND MARKET ECONOMY: REINTERPRETING THE VALUES OF LAW AND ECONOMICS (2000) [hereinafter MALLOY, MARKET ECONOMY]; ROBIN PAUL MALLOY, LAW IN A MARKET CONTEXT: AN INTRODUCTION TO MARKET CONCEPTS IN LEGAL REASONING (2004) [hereinafter MALLOY, MARKET CONTEXT]. A major idea expressed in each book is that markets are about exchange and not simply about an amoral calculus of choice. It is important to understand such things as who initiates exchange, what is permitted to be exchanged, on what terms does exchange take place, and what remedies are available for breach. There are socio-economic and racial dimensions to exchange relationships. Moreover, in exchange theory, we understand that choice is always preceded by belief, and therefore it is important to study the fixation of belief from the perspective of cultural-interpretation theory. Exchange takes place in a social context and involves complex dynamics unable to be fully captured in the economics of the self-interested pursuit of wealth maximization.

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market, I focus my analysis on an evaluation of the underlying real estate transaction and the related activities of the primary mortgage market. I do this because of time and space limitations and because I believe we need to have a sound regulatory approach to the underlying real estate transaction if we want to ultimately have improved financial regulation of the secondary market, as well as of the market for mortgage related securities.

In developing this argument I proceed in several steps. First, I discuss the fallacy of self-correcting markets as a way of explaining the need for volitional and purposeful regulation in the housing and mortgage markets. Second, I provide an overview of the basic exchange relationships among the parties involved in the underlying real estate transaction, those in the primary and secondary mortgage market, and potential investors in mortgage related securities. And third, I suggest a series of regulatory reforms for improving the soundness of the underlying real estate transaction and the operation of the primary mortgage markets. These reforms include measures that fall into three thematic categories: taking steps to reduce speculation in housing prices; eliminating incentives for over-borrowing and over-lending; and adjusting the structure of the underlying real estate transaction to undermine the incentive for degraded transactions and the tendency toward an inverse prisoner's dilemma problem.[5]

II. The Fallacy of Self-Correcting Markets

Markets are not objects that can be observed and studied as something real. Markets are dynamic and involve the complex human activity of exchange. Markets, much like legal systems, can be informal or formal. Most modern markets of major significance, however, tend to be formal and are the institutional product of human action. In particular, housing and mortgage markets are formal institutional frameworks that rely on legal infrastructure to facilitate long distance and impersonal exchange networks of trade and exchange. Distant

5. *See, e.g.*, MALLOY, MARKET CONTEXT, *supra* note 4, at 130-32. *See generally, e.g.*, Richard H. McAdams, *Beyond the Prisoners' Dilemma: Coordination, Game Theory, and Law*, 82 S. CAL. L. REV. 209 (2009).

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investors, lenders, buyers and sellers all rely on a belief in the soundness of housing and mortgage market institutions in order to facilitate a complex set of exchanges.

Economists often talk about markets as if they are real objects and as if people simply find themselves placed in naturally existing market environments in which they respond to stimuli by taking self-interested actions to maximize their own wealth. This idea of the market as a real place is, however, a metaphor, as are the many models that economists generate and use to describe markets.[6] The economists' idea of the market is a representation or model of the underlying networks and patterns of human exchange; it is not itself the real to which it refers, just as a map of a given city or of the world is not the real to which it makes reference.[7] Such maps and models are always partial and incomplete even though they may serve to convey important information with respect to certain characteristics or qualities of the real that they represent.[8] These models are constructed within the assumptions of economics which function as a kind of math-based sociology in an effort to describe the process of human exchange.

In explaining their models of market behavior, economists often speak in terms of markets as being "self-correcting." When one speaks in terms of self-correcting markets one offers an iteration on Adam Smith's *invisible hand* metaphor.[9] This means that markets are suggested to be real, physical places capable of automatically adjusting to continuously changing circumstances, and doing so in a way that simultaneously maximizes efficiency and wealth for individuals and the public alike.[10] According to some, all of this happens as if the market

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6. *See* MALLOY, MARKET ECONOMY, *supra* note 4; DEIRDRE N. MCCLOSKEY, IF YOU'RE SO SMART: THE NARRATIVE OF ECONOMIC EXPERTISE (1990); DEIRDRE N. MCCLOSKEY, THE RHETORIC OF ECONOMICS (2d ed. 1998).

7. *See* MALLOY, MARKET ECONOMY, *supra* note 4; MALLOY, MARKET CONTEXT, *supra* note 4.

8. *See* MALLOY, MARKET ECONOMY, *supra* note 4; MALLOY, MARKET CONTEXT, *supra* note 4.

9. *See supra* note 2.

10. *See* MALLOY, MARKET ECONOMY, *supra* note 4, at 4, 88, 127, 138, 150 (noting that efficiency is a complex and ambiguous concept as any distribution can be efficient, and no optimal course of action can be determined in a complex system); MALLOY, MARKET CONTEXT, *supra* note 4, at

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were being directed by an invisible hand. The upshot of this, however, is a belief that such a model renders unnecessary most, if not all, government regulation of the market. If markets are real, natural, and continuously self-balancing, there is little for government to do. This belief, however, ignores the fact that formal markets are the institutional products of volitional human action, and these institutions both constrain and incentivize particular networks and patterns of exchange; they privilege particular types of transactions and approaches to transactions, even if they do not dictate a given individual exchange.

Economists also speak in terms of self-correcting prices but this is a matter quite different from the assertion of self-correcting markets. Price is simply an interpretation of value and any given set of prices reflect value differences among and between available items within a given institutional market framework.[11] As relative value changes within a given system, prices adjust to signal the relative changes. The process of signally relative changes in underlying values within a given system is different than saying that the institutional product of human action itself is self-correcting.[12]

In part, the current crisis in the U.S. housing and mortgage market results from a misunderstanding of markets on the part of government policy makers and regulators.[13]

27-30 (noting that Smith's invisible hand theory is often presented as an invariance argument in support of a claim that private parties pursuing their own self-interest end up promoting, in an equivalent fashion, the public interest. There is, however, variance between private interest and public interest – meaning that there are inequalities between marginal public costs and benefits, as well as marginal private costs and benefits.).

11. Price, as an interpretation of value, is a well-accepted concept in semiotics; as an interpretation of value, it is relational with respect to other available options. *See* MALLOY, MARKET ECONOMY, *supra* note 4, at 18-20, 30-32, 45-46.

12. A major element of a sound market exchange process is that prices are permitted to equilibrate freely so that relative values can be signaled to participants in exchange. This permits a good flow of information regarding the prioritization of system-based incentive structures.

13. *See* Edmund L. Andrews, *Greenspan Concedes Flaws in Deregulatory Approach*, N.Y. TIMES, Oct. 24, 2008, at B1; Rick Brooks, *The United States of Subprime; Data Shows Bad Loans Permeate the Nation*, WALL ST. J., Oct. 11, 2007, at A1; Phil Gramm, *Deregulation and the Financial Panic*, WALL ST. J., Feb. 20, 2009, at A17; Kara Scannell, *Greenspan Admits Errors to Panel*, WALL ST. J., Oct. 24, 2008, at A15; John B. Taylor, *How Government Created*

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Under the Bush administration, singing in harmony with the Chicago School law and economics types, markets were understood as self-correcting and capable of coordinating complex exchanges with little or no need for government interference or oversight. Market analysis is presented as a rational and self-interested calculus of choice designed to promote efficiency and the maximization of wealth.[14] The problem with the Chicago School approach is that it fails to understand the distinction between economics and markets, and more particularly, the economic analysis of law and the idea of law in a market context.[15] Economics is an academic discipline grounded around certain assumptions and principles that define its mode of inquiry from that of other social sciences and forms of thinking.[16] Like other fields of academic inquiry that approach law and policy, economics helps one to organize interesting questions and uncover valuable insights. Also like other fields of social inquiry it is not fully determinate and is limited in its ability to represent the real world of exchange to which it refers. Moreover, while it is important to consider law in its market context, this is quite different from suggesting that law can be optimized via an economic calculus.[17]

In reality, markets are about the networks and patterns of exchange and not the economic calculus of choice.[18] Markets involve communities of interaction and the establishment of cultural-interpretive norms of exchange. In markets, self-interest is informed by a dynamic relationship between the

the Financial Crisis, WALL ST. J., Feb. 9, 2009, at A19. Fixing the problem is also proving difficult for policy makers. For example, early efforts at modifying individual home mortgages to avoid foreclosure revealed that "[m]ore than half of homeowners fell behind on mortgage payments in the first six months after their loans were modified." Ruth Simon, *Easing Mortgages Isn't a Panacea – Bank Data Show Many Homeowners Falling Behind Soon After Loans are Modified*, WALL ST. J., Dec. 9, 2008, at A4.

14. *See* MALLOY, MARKET ECONOMY, *supra* note 4; MALLOY, MARKET CONTEXT, *supra* note 4.

15. *See* MALLOY, MARKET ECONOMY, *supra* note 4; MALLOY, MARKET CONTEXT, *supra* note 4.

16. *See* MALLOY, MARKET ECONOMY, *supra* note 4; MALLOY, MARKET CONTEXT, *supra* note 4.

17. *See* MALLOY, MARKET ECONOMY, *supra* note 4; MALLOY, MARKET CONTEXT, *supra* note 4.

18. *See* MALLOY, MARKET ECONOMY, *supra* note 4; MALLOY, MARKET CONTEXT, *supra* note 4.

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individual and the community, and price is understood as an interpretation of value and not value itself.[19] In looking at law in a market context, we understand the significance of market dynamics and economic insights, and at the same time, recognize that there is no way to identify an optimal legal rule or course of action, that efficiency is an ambiguous concept that can be easily manipulated, and that wealth maximization simply maximizes an institutional bias in favor of those who already have wealth.[20] Economics is simply a stylized way of representing particular aspects of the exchange process. It is one way of interpreting elements of the complex human experience of exchange, and as such, it is always and everywhere partial and incomplete in its ability to represent that to which it makes reference.[21] Nonetheless, policy makers and government officials invoke economic models as rhetorical devices to promote amoral and strategic game-like behavior wherein the accumulation of wealth is celebrated as the highest claim to success, achievement, and social worth. The ultimate display of the failure of the Chicago School approach to treating law as the object of economic calculus is the collapse of the housing and mortgage markets.[22]

Markets are not self correcting in economic terms. In economic terms, markets have to be defined, rights assigned, allocation rules established, and other institutional structures put in place. With a given approach to trade and exchange, people can interact in accordance with the established rules of the game and prices will adjust in a price system to reflect relative values among competing goods and resources. Prices in this system are self-correcting precisely because they are simply markers or signs of relative relationships between values in a given institutional or environmental context. These institutional structures and practices stay in place as long as

19. *See* MALLOY, MARKET ECONOMY, *supra* note 4; MALLOY, MARKET CONTEXT, *supra* note 4.

20. *See* MALLOY, MARKET ECONOMY, *supra* note 4; MALLOY, MARKET CONTEXT, *supra* note 4.

21. *See* MALLOY, MARKET ECONOMY, *supra* note 4; MALLOY, MARKET CONTEXT, *supra* note 4.

22. The size of the worldwide losses on bad loans and securitization are estimated to be $4.1 trillion, according to the International Monetary Fund (IMF). Harry Maurer & Cristina Linblad, *One Nasty Slump*, BUS. WK., May 4, 2009, at 5.

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there is a belief in their ability to promote and deliver particular value-based outcomes in a cost-effective manner.[23] With globalization, pressing social and environmental problems, and dramatic disparities in access to resources, the American narrative of the unfettered and individual pursuit of wealth and greed is coming to a rapid demise; as practiced, it is simply no longer credible to many people.

Markets are built on trust, duty, prudence, loyalty, tradition, discipline and rules. Markets do not function in an amoral context. Markets are about people exchanging and interacting in community, and more and more people are realizing that markets are not self-correcting. Rather, people correct markets and people change the institutional structures and incentives.[24] The misplaced belief in the idea of self-correcting markets allowed housing and mortgage markets to be exploited and degraded by actors seeking only to maximize their own self gain.

Housing and mortgage markets have been and continue to be heavily subsidized and supported by active government intervention to achieve cost-effective outcomes in housing policy.[25] This is perhaps one of the most ironic elements of the claim by law and economics types that markets are self-correcting and natural. Modern housing and mortgage markets function as clear examples of institutionally created and managed exchange networks, making it difficult to believe that the people who created these markets think that they are actually self-forming and re-forming.

In earlier days, people typically either bought property for cash, as part of a service for ownership arrangement, or on credit terms of a short duration such as five years.[26] This kept ownership rates relatively low by today's standards.[27] In an

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23. The focus on belief is important as a precursor to choice in the semiotics of Charles S. Peirce and his theory of abductive logic. *See* BROMLEY, *supra* note 1, at 19, 88-151; MALLOY, MARKET CONTEXT, *supra* note 4, at 93-104.

24. *See* BROMLEY, *supra* note 1, at 1-19.

25. *See generally* AFFORDABLE HOUSING AND PUBLIC-PRIVATE PARTNERSHIPS (Nestor M. Davidson & Robin Paul Malloy, eds., 2009).

26. *See generally* Robin Paul Malloy, *The Secondary Mortgage Market: A Catalyst for Change in Real Estate Transactions*, 39 SW. L.J. 991 (1986).

27. At the time of World War II homeownership rates in the United States were at about 43.6%; as of 2004 they were at about 70%. ROBIN PAUL

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effort to purposefully advance access to ownership and increase ownership rates, the government created special lending institutions, mortgage forms, and lending regulations.[28] After World War II, government-sponsored activities expanded. Using the Federal Housing Administration, Veterans Administration, and other loan devices, along with efforts by Fannie Mae, Freddie Mac, and Ginnie Mae, the government intervened to create a much expanded credit market in support of residential home ownership.[29] These interventions provided low-cost mortgage loans, extended the length of credit repayment terms, and provided mortgage insurance that was particularly important to borrowers in need of low down payments.[30] By the year 1980, the government had created an even more expansive market for housing credit with its development of the secondary mortgage market.[31] This new market further extended affordable credit for home ownership, and offered greater liquidity and risk reduction for primary mortgage market lenders. Primary market lenders could then enjoy a ready market for the sale of the mortgage loans that they originated. Furthermore, the amount of loanable funds increased dramatically as mortgage-related securities were sold through general capital markets to investors who had previously not purchased market instruments from real estate related intermediaries—or at least not instruments that pushed money back into further loan originations and additional real estate transactions.

Government involvement was critical for the development of the secondary mortgage market for several reasons. First, developing a fully functioning and national market for

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MALLOY & JAMES CHARLES SMITH, REAL ESTATE TRANSACTIONS 313-14 (3d ed. 2007). In more recent years, the U.S. homeownership rates have generally been in the mid-to-high 60% rate, with the time period between 1994 and 2004 showing significant increases in the diversity of the home-owning population. *Id.*

28. *See id.* at 379-83; ROBIN PAUL MALLOY & JAMES CHARLES SMITH, REAL ESTATE TRANSACTIONS 725-50 (1st ed. 1998); GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW 916-1011 (5th ed. 2007).

29. *See generally* Malloy, *supra* note 26; NELSON & WHITMAN, *supra* note 28.

30. *See generally* Malloy, *supra* note 26; NELSON & WHITMAN, *supra* note 28.

31. *See* MALLOY & SMITH, *supra* note 27, at 379-83; MALLOY & SMITH, *supra* note 28, at 725-50; NELSON & WHITMAN, *supra* note 28, at 916-1011.

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individual home mortgages that originated in banks from coast to coast raised tremendous coordination problems. Second, state law involving property, mortgages, and foreclosure varied among the States, raising huge transaction costs for coordinating information, documentation, and the pooling of mortgages.[32] Third, the technology for tracking the details, monthly payments, and other requirements of millions of discrete home mortgages was extremely difficult to organize without major investments in integrated technology systems and protocols that could only reasonably result from federal involvement. And fourth, it is unlikely that many private investors would have invested in the mortgage-related securities without an understanding that they were to have indirect, if not direct, government backing.[33] This not only reduced investment risk generally, but it also made the mortgage backed securities more competitive with private securities by reducing the discount that would otherwise have been applied to these offerings.[34]

With the secondary market, the government created and sponsored the institutional framework for transforming mortgages into securities capable of attracting resources from the general capital markets. The history of housing and mortgage markets in the United States is one of continuous and purposeful adjustment and readjustment of institutionally incentivized exchange relationships, and not one of self-emerging and self-correcting markets.[35]

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32. *See generally* DAVID S. HILL & CAROL BROWN, BASIC MORTGAGE LAW (2007); MALLOY & SMITH, *supra* note 27; MALLOY & SMITH, *supra* note 28; Malloy, *supra* note 26; NELSON & WHITMAN, *supra* note 28; Gant S. Nelson & Dale A. Whitman, *Reforming Foreclosure: The Uniform Non-Judicial Foreclosure Act*, 53 DUKE L.J. 1399 (2004).

33. *See generally* Richard Scott Carnell, *Handling the Failure of a Government-Sponsored Enterprise*, 80 WASH. L. REV. 565 (2005); David Reiss, *The Federal Government's Implied Guarantee of Fannie Mae and Freddie Mac's Obligations: Uncle Sam Will Pick Up the Tab*, 42 GA. L. REV. 1019 (2008).

34. Joseph Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369, 1383 (1991).

35. For a discussion of federal taxation subsidies, see generally Chad D. Emerson, *All Sprawled Out: How the Federal Regulatory System Has Driven Unsustainable Growth*, 75 TENN. L. REV. 411, 423 (2008); M.H. Hoeflich & John E. Thies, *Rethinking American Housing Policy: Defederalizing Subsidized Housing*, 1987 U. ILL. L. REV. 629 (1987); and Roberta F. Mann,

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This background helps put into context an October 24, 2008, report in the *Wall Street Journal* by economist and former Federal Reserve Chairman Alan Greenspan, declaring his "shocked disbelief" that financial institutions had failed to protect themselves from risk tied to mortgage securities.[36] It was a statement of shock that has been much ridiculed as one of not understanding that self-interested people often do not in fact end up promoting the public interest and for continuing to believe that markets are continuously self-correcting as if lead by an invisible hand with no need for regulation or appropriate oversight.

In my mind, Greenspan's shocked disbelief echoes a classic line from the film *Casablanca* when Claude Rains, as Captain Renault, is ordered by the Germans to shut down Rick's Café.[37] Renault quips that he has no legal reason to close Rick's, to

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The (Not So) Little House on the Prairie: The Hidden Costs of the Home Mortgage Interest Deduction, 32 ARIZ. ST. L.J. 1347 (2000). For a discussion on the history of FHA and VA loans, see Adam Gordon, *The Creation of Homeownership: How New Deal Changes in Banking Regulation Simultaneously Made Homeownership Accessible to Whites and Out of Reach for Blacks*, 115 YALE L.J. 186, 194-96 (2005); and Florence Wagman Roisman, *National Ingratitude: The Egregious Deficiencies of the United States' Housing Programs for Veterans and the "Public Scandal" of Veterans' Homelessness*, 38 IND. L. REV. 103, 112-46 (2005). *See also generally* Quintin Johnstone, *Private Mortgage Insurance*, 39 WAKE FOREST L. REV. 783 (2004). For a discussion on the government's role in the development of the secondary mortgage market, see Julia Patterson Forrester, *Mortgaging the American Dream: A Critical Evaluation of the Federal Government's Promotion of Home Equity Financing*, 69 TUL. L. REV. 373, 394-97 (1994); and Cathy Lesser Mansfield, *The Road to Subprime "Hel" Was Paved With Good Congressional Intentions*: *Usury Deregulation and the Subprime Home Equity Market*, 51 S.C. L. REV. 473, 476 (2000). For a discussion of the government's role in the creation of uniform lending documents, see Christopher L. Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV. 2185, 2226-27 (2007); and see generally Arthur W. Leibold, Jr., *Uniform Conventional Mortgage Documents: FHLMC Style*, 7 REAL PROP. PROB. & TR. J. 435 (1972). For a history of the government's role in creating Fannie Mae and Freddie Mac, see generally Carnell, *supra* note 33; Reiss, *supra* note 33.

36. Scannell, *supra* note 13 (noting that the Federal Reserve Chairman, Alan Greenspan, declared his "shocked disbelief" that financial institutions had failed to protect themselves from risks tied to mortgage securities, and that "Greenspan said he made 'a mistake' in his hands-off regulatory philosophy, which many now blame in part for sparking the global economic troubles. . . . He conceded that he has 'found a flaw' in his ideology and said he was 'distressed by that.'").

37. CASABLANCA (Warner Brothers 1943). *See also* HOWARD KOCH, CASABLANCA: SCRIPT AND LEGEND 176-77 (1992).

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which the Germans command, "find one."[38] In manufacturing an excuse to legally close the Café, Captain Renault walks toward the casino, collects his gambling payout for the night, and simultaneously declares to Rick (played by Humphrey Bogart) that the Café must be closed immediately, as he is "shocked, shocked to find gambling is going on in here!"[39] Of course, Claude Rains's lines were delivered for amusement whereas Greenspan's shocked disbelief reveals something tragic in the regulatory ideology of the United States. For Greenspan to be in shocked disbelief demonstrates either an ideological commitment to certain assumptions that are so deep that they blinded his perception of the reality going on around him, or a level of disingenuous rhetoric that is in its own way as lacking in credibility as the declaration of Captain Renault in *Casablanca*.

The bottom line is that markets are not, and should not be, self-correcting. The fallacy of self-correcting markets and the false rhetoric of the neoclassical law and economics types is one of promoting the idea of the market as a desirable end in itself. Markets are not an end, they are a means; specifically, they are a means for arranging exchange networks in ways that permit individuals and communities to cost effectively pursue volitional goals and objectives that they believe are normatively, ethically and aesthetically desirable.[40] Markets are shaped by public policy and need regulation and oversight to continuously confirm their cost-effective ability to assist in the achievement of the desired ends. Real estate markets are no exception.

III. A Real Estate Transactions Perspective on Mortgage Markets

Real estate transactions involve the capturing and creating of value from exchange. I sometimes refer to this as "property in action." Through trade and exchange, opportunities for capturing and creating value emerge and these opportunities

38. CASABLANCA, *supra* note 37. *See also* KOCH, *supra* note 37, at 176-77.

39. CASABLANCA, *supra* note 37. *See also* KOCH, *supra* note 37, at 176-77.

40. *See generally* MALLOY, MARKET ECONOMY, *supra* note 4, at 106-40; BROMLEY, *supra* note 1.

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incentivize further trades and exchanges. These underlying transactions occur at the primary market level and form the ground and foundation for secondary market activities such as those in the secondary mortgage market.

This part of the article addresses the exchange relationships among key participants in the primary market, the secondary market, and the third party investors in mortgage related securities. It finishes with a brief discussion on the regulatory importance of dealing with the underlying real estate transaction as fundamental to any effort to reform the secondary market and its securities based operations.

A. *The Primary Market*

At the core of every transaction in mortgaged backed securities is an underlying transaction in real estate. Thus, we need to understand the nature and quality of the underlying transaction if we hope to get a handle on the current crisis in financial markets.

In a basic home sale transaction we have three transactional perspectives to consider.[41] The primary parties to a purchase and sale agreement are the buyer and the seller of the property. The secondary parties to this transaction are those who are engaged in administrative and managerial transactions related to the basic purchase and sale agreement. These parties may typically include: brokers, attorneys, a title company, an insurance company, a surveyor, and a loan originator for the mortgage loan. The transcendent third parties are not directly involved in the deal but have a potential future interest in the underlying transaction. These include people meant to be protected by the maintenance of the public records and potential investors further down the transactional chain, or potential future buyers and creditors.[42]

The basic exchange relationship of a real estate transaction is illustrated in Diagram I, below.

41. *See generally* MALLOY & SMITH, *supra* note 27 (discussing basic coverage of the various aspects of law important to real estate transactions).

42. *See id.* at 231-68 (discussing the public records).

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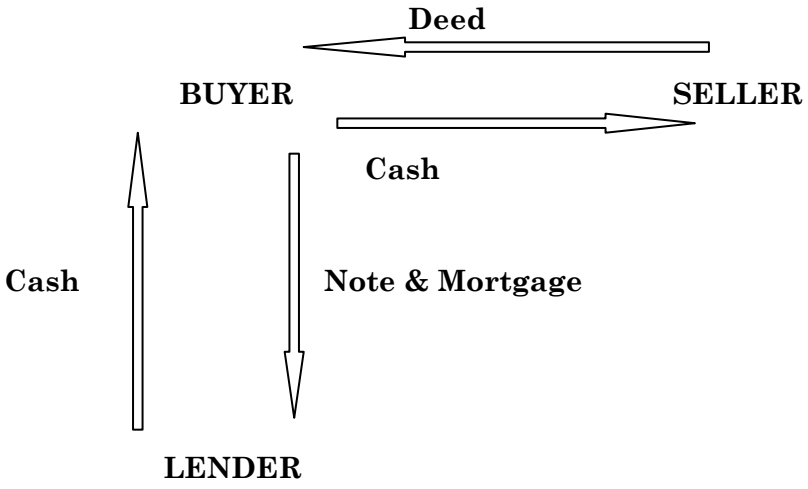

DIAGRAM I. REAL ESTATE TRANSACTIONS AND THE PRIMARY MORTGAGE MARKET

The basic real estate transaction is illustrated in Diagram I. Seller conveys the agreed upon interest in property to the buyer for a benefit.[43] A typical transaction involves a money payment in exchange for delivery of a deed. Frequently the buyer does not pay the full purchase price out of her own resources. Instead the transaction is leveraged as the buyer finances a large portion of the expense.[44] This is shown on the left-vertical side of the diagram. In a standard home loan, the lender of the funds secures the repayment of the loan with a promissory note and a mortgage. This provides a conditional claim to the property in the event that the buyer/borrower does not live up to the terms of the promise to repay.

This set of exchange relationships can be very much localized in the absence of a secondary market for mortgages.[45] In such a case, the lender would make the loan and hold it in its investment loan portfolio.[46] The lender would need to

43. *See id.* at 1-180 (discussing basic contract considerations).

44. *See id.* at 367-510 (discussing basic mortgage considerations).

45. *See* MALLOY, MARKET ECONOMY, *supra* note 4, at 50-57 (discussing how the secondary mortgage market transformed the local home financing system).

46. *See generally* MALLOY & SMITH, *supra* note 27; MALLOY & SMITH, *supra* note 28.

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maintain a positive spread between its cost of funds and the return on its investments.[47] In the event that risky loans are made, it would impact on the financial stability of the lender and any losses would be borne by that institution.

The relationships in this exchange situation establish a congruence of interest between borrower and lender, at least to the extent that each wants the underlying deal and its documentation to be correct, enforceable, and consistent with their risk and investment expectations. As to sellers, once they get their cash they often have little interest in what happens next, unless they have some serious continuing liability under the terms of the conveyance. Such a continuing liability is likely to arise under the instrument of conveyance, and typically not on the contract, because of the doctrine of merger.[48]

In securing financing for the purchase of the property, buyer enters the primary mortgage market. Diagram II, below, illustrates the basic exchange relationships in the primary mortgage market.

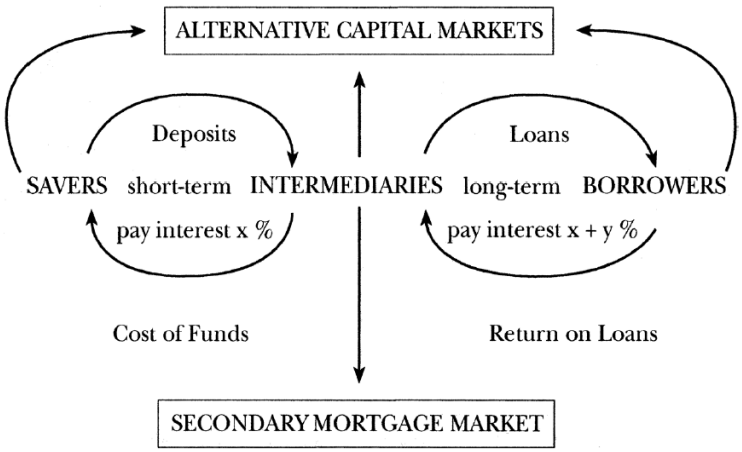

DIAGRAM II. THE PRIMARY MORTGAGE MARKET[49]

47. *See generally* MALLOY & SMITH, *supra* note 27; MALLOY & SMITH, *supra* note 28.

48. *See* MALLOY & SMITH, *supra* note 27, at 145-52 (discussing the doctrine of merger).

49. MALLOY & SMITH, *supra* note 27, at 380 (used with permission). For background on primary markets, see also Raymond H. Brescia, *Capital in*

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In Diagram II, we see the primary transaction as it appears when a primary mortgage market is established to interface with other financial networks. In this diagram we see that savers and borrowers have options in the marketplace. There are multiple sources for lending and multiple places to invest one's savings. Financial intermediaries function to bring savers and borrowers together and make a profit by keeping a positive spread between their cost of funds and the return on their investments. In real estate transactions we have intermediaries that deal in mortgages; they compete for savers/investors against other types of investments available in the broader capital markets, such as the market for corporate stocks and bonds. The lenders that make the loans to the parties in the underlying real estate transaction are the originators of the primary mortgages. They often use in-house or external mortgage brokers who work for fees and commissions to originate the mortgages. Primary lenders should basically provide confirmation as to certain aspects of the underlying real estate transaction by verifying such things as the title and property appraisal value in relation to the contract, mortgage, and price terms. This verification process should be based on underwriting standards meant to reduce the risk of default.

B. *The Secondary Market*

The secondary mortgage market creates opportunities for primary lenders to sell the mortgages that they originate.[50] This enhances liquidity, reduces risk by diversifying the primary lender's investment portfolio, and increases the

Chaos: The Subprime Mortgage Crisis and the Social Capital Response, 56 CLEV. ST. L. REV. 271, 285 (2008); Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1278-79 (2002); and Aaron Unterman, *Exporting Risk: Global Implications of the Securitization of U.S. Housing Debt*, 4 HASTINGS BUS. L.J. 77, 79-80 (2008). *See also generally* Peterson, *supra* note 35, at 2199; Ronald K. Schuster, *Lending Discrimination: Is the Secondary Market Helping to Make the "American Dream" a Reality?*, 36 GONZ. L. REV. 153, 155-57 (2000-2001).

50. *See generally* MALLOY & SMITH, *supra* note 27; MALLOY & SMITH, *supra* note 28; NELSON & WHITMAN, *supra* note 28; Malloy, *supra* note 26; *supra* note 27 and accompanying text.

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available funds for lending by recharging the assets of the primary lender.[51] There are both public- and private-related entities functioning as secondary mortgage market intermediaries. They buy and sell loans and loan participations, as well as package loans into pools for securitization. They issue various mortgage related securities and bonds, and sell them into the financial markets.[52] Diagram III, below, illustrates the basic exchange relationships of the secondary mortgage market.

The secondary mortgage market not only creates a market for primary mortgages, but it also changes the underlying relationships in the primary market. Prior to the secondary market's emergence around 1980, the primary lenders originated and held their loans.[53] This gave them a vested interest in the quality of the loans and in maintaining good relations with their customers. With the rise of the secondary market, primary lenders were able to sell the mortgages at par (face value and without a discount)[54] to recharge their assets, and this provided the opportunity to make money from fees for generating new mortgages rather than from simply originating and holding loans as an investment. In this new situation, lenders shifted their focus to providing services and products welcomed by the secondary market intermediaries.[55] The local homebuyer seeking a loan became much less significant to banking operations as money was to be made in churning the paper of loan originations rather than by cultivating relationships based on long-term lend and hold investment

51. *See generally* MALLOY & SMITH, *supra* note 27; MALLOY & SMITH, *supra* note 28; NELSON & WHITMAN, *supra* note 28; Malloy, *supra* note 26; *supra* note 27 and accompanying text.

52. For additional background on issues related to the secondary mortgage market and securitization, see generally Kenneth C. Kettering, *Securitization and its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553 (2008); and David Reiss, *Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market*, 33 FLA. ST. U. L. REV. 985 (2006).

53. *See generally* Malloy, *supra* note 26.

54. One way this is done is by using points that can be passed on to the borrower as closing costs, with the points covering the amount that otherwise would be discounted against face value. *See* MALLOY & SMITH, *supra* note 27, at 383-84.

55. *See* MALLOY, MARKET ECONOMY, *supra* note 4, at 50-57. *See generally* Malloy, *supra* note 26.

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strategies.[56] Transactions became more uniform, standardized, and driven by a desire for fee and servicing income based on relatively quick sales of mortgages to the secondary market intermediaries.[57]

The secondary market also created an exchange environment that influenced behavior in the primary market, beyond that of switching from a loan and hold, to a fund and sell operation. Primary lenders began to adjust their underwriting standards and their risk tolerance based on the willingness of secondary market intermediaries to take non-conforming and subprime loans.[58] As long as there was a market for what they originated, the primary lenders could simply collect their fees and sell the loan off to recharge their asset-base and make more fee income. The underlying economic goal of this behavior was not to limit one's self to some personal or idealized standard of loan quality, but to maximize profit based on what one can sell in the relevant secondary market. The underwriting standards of the secondary market intermediaries (the entities purchasing loans from originators in the primary market) changed over time, making it easier to fund more borrowers for home mortgages. As the secondary market underwriting standards were made easier, primary market originators adjusted their activities to reflect tolerance for greater risk.

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56. *See* MALLOY, MARKET ECONOMY, *supra* note 4, at 50-57. *See generally* Malloy, *supra* note 26.

57. *See* MALLOY, MARKET ECONOMY, *supra* note 4, at 50-57. *See generally* Malloy, *supra* note 26.

58. For a discussion on these lowered lending standards, see generally Brescia, *supra* note 49, at 295; Benjamin Howell, *Exploiting Race and Space: Concentrated Subprime Lending as Housing Discrimination*, 94 CAL. L. REV. 101, 124-27 (2006); and Rayth T. Myers, *Foreclosing on the Subprime Loan Crisis: Why Current Regulations are Flawed and What is Needed to Stop Another Crisis From Occurring*, 87 OR. L. REV. 311, 313-16 (2008). Lower standards also included use of negative amortization loans, and piggy back financing, where a lender would fund the borrower's 20% equity requirement with a second mortgage so that the borrower really had no equity in the property. MALLOY & SMITH, *supra* note 27, at 383-99.

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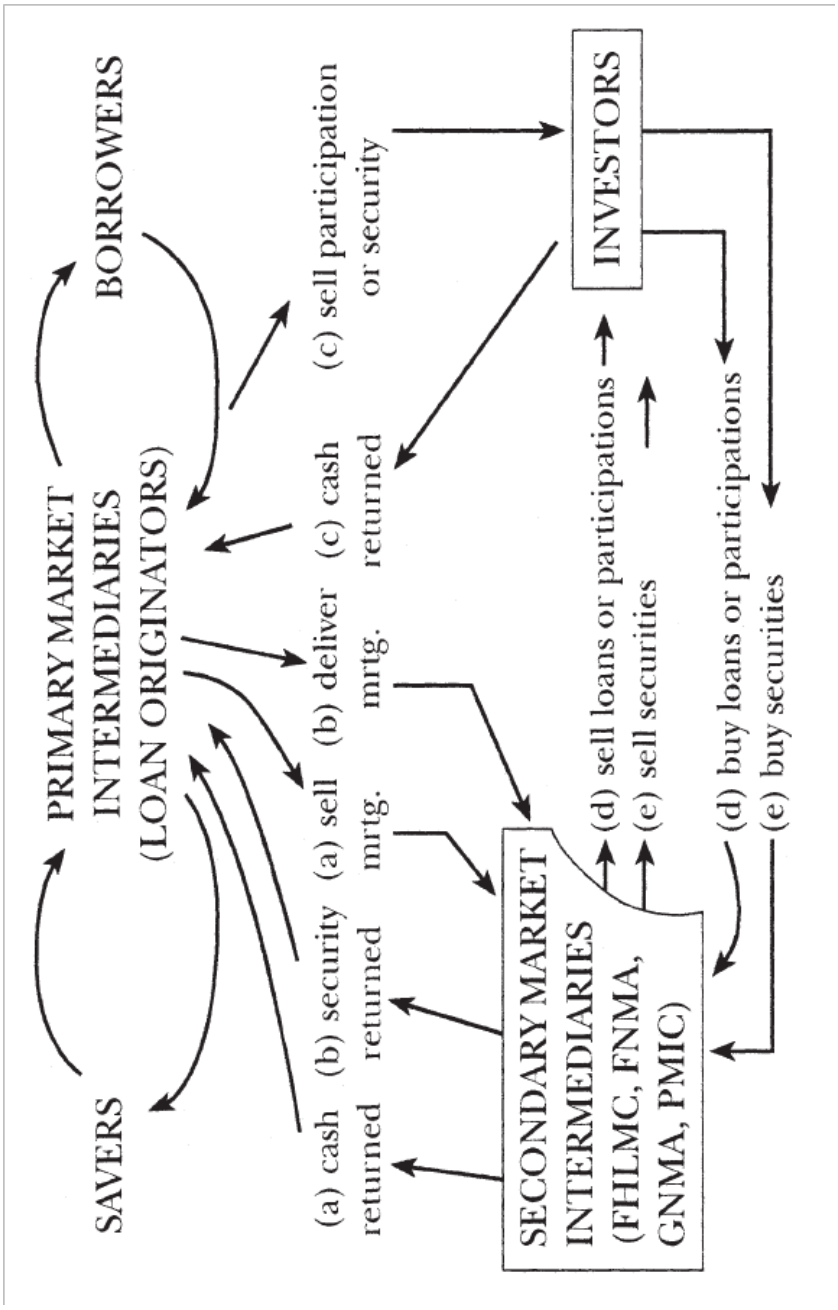
DIAGRAM III. THE SECONDARY MORTGAGE MARKET[59]



59. MALLOY & SMITH, *supra* note 27, at 382 (used with permission).

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C. *Third Party Investors*

Third party investors purchase securities issued against the anticipated and expected value of the cash flow on the underlying mortgages associated with a given issue. The underlying cash flow supports the value of the security but the investor does not typically become an owner of the mortgage loans themselves. On the other hand, some investors purchase loan participations that give them direct rights to cash flow of a given underlying mortgage or mortgages. In either situation, early payoffs from refinancing can impact the expected value of the cash flow, as can defaults and foreclosures. Thus, accurate pricing and valuation depend on the quality of the underlying transactions; and, more particularly, on the quality, validity, and authenticity of the information about the underlying transactions.[60]

Investors have little firsthand knowledge of the underlying documentation or of the legal rules applicable to the underlying transaction. They rely on the basic uniformity of standardized mortgage documents, and the fact that both the primary and secondary intermediaries approved the loans. This reliance factor is enhanced by the presence of two very dominant entities with implicit, although not express, backing of the United States Government: Fannie Mae and Freddie Mac. In fact, it is known that the Federal Government encouraged loan originations based on new and lower underwriting standards.[61]

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60. Much of what we do in a transactional law practice involves what I have called "transactional authentication". This means we spend time confirming the authenticity of the buyer, seller, the documents, the property, the reality of the mortgage, and the credit behind it, etc. These transactions are in paper, or else take place as representations of the property and the debt, and we must confirm that the representations are of something that is real. For instance, the presence of a paper deed does not verify the existence of the actual property to which the deed refers. As to pricing, there are a number of issues, including calculation of the expected life of the mortgage as opposed to its term. A typical residential mortgage will be for a stated term of thirty years but in reality, the life will be very much shorter. This occurs for several reasons, including a sale of the home, a refinance, or a default. The typical American moves about every five years, for instance. *See* Robin Paul Malloy, *Inclusion by Design: Accessible Housing and Mobility Impairment*, 60 HASTINGS L.J. 699, 726-28 (2009) (discussing housing demographics).

61. *See* Russell Roberts, *How Government Stoked the Mania*, WALL ST. J., Oct. 3, 2008, at A21. Congress pushed Fannie Mae and Freddie Mac to

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This was part of a volitional policy of enhancing home ownership rates across more income ranges and all racial categories by making it easier for more and more people to get into a home.

In addition to encouraging greater flexibility and ease of loan approval, the leadership of Fannie Mae and Freddie Mac earned incentive pay and bonuses based on hitting and exceeding targeted goals in loan originations made to people who would not likely qualify under the standards for traditional conventional mortgages.[62] In this way the organizations that many Americans mistakenly believed were policing the mortgage markets were in fact being incentivized to profit from lower standards of supervision and underwriting. In fact, no government entity was supervising the mortgage markets, given that Fannie and Freddie were not technically government entities, and given that they had an incentive to participate in bad practices rather than to actively regulate against them.

In this rather odd arrangement, third party investors relied on the approval of the secondary market intermediaries as a form of confirmation as to the quality of the underlying loans, and at the same time the secondary market intermediaries relied on continuing investor interest as confirmation of the market for its products. Thus, as long as the products were able to find a market, they were believed to be sound. In theory, if these products were not believed to be sound, rational and self-interested actors would not buy them. In the world of standard neoclassical economics, as used by many law and economics practitioners, this is the world of self-correcting markets and circular absurdity. The circularity of the logic goes something like this: the securities being issued to

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make more and more loans to people of lower income, and many of these loans were in the troubled subprime mortgage markets. *Id*. "Fannie and Freddie played a significant role in the explosion of subprime mortgages and subprime mortgage-backed securities." *Id. See also* Ruth Simon, *Mortgages Made in 2007 Go Bad at Rapid Clip*, WALL ST. J., Aug. 7, 2008, at A3. "Evidence that lax lending standards were leading to higher mortgage delinquencies first emerged in late 2006." *Id.*

62. *See* James R. Hagerty et al., *After Fannie Shake-Up, Regulators Focus on Pay*, WALL ST. J., Dec. 23, 2004, at A1; James R. Hagerty, *Fannie Will Use New Benchmarks in Setting Incentive Pay for 2005*, WALL ST. J., Mar. 14, 2005, at A2.

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investors were good because the investors bought them, and because the investors bought them, the intermediaries knew that the new and lower underwriting standards were sound so they could keep originating and selling these products.

In the process of packaging and selling mortgaged-based securities, many complicated financing devices and insurance arrangements obscured information for investors, but to a certain extent the impact of the financial complications are uncertain since many of the investors in these mortgage-related instruments were simply buying each other's obligations. In other words, primary market originators were also active investors; thus, investors were, in part, buying each other's bad loans.[63]

The government-supported outcomes of this incentivized market structure were that it did increase home ownership rates across a diverse racial spectrum, and in addition, it added to the growth of the money supply.[64] In buying mortgages through the secondary market, the government pumps money into the mortgage markets and recharges the asset base of primary mortgage lenders. In this way more money circulates in the economy permitting a sense of economic growth. This is an indirect way to mask a government stimulus package that drives economic activity in the wake of rising deficits and bad economic fundamentals due to huge expenditures allocated to the War on Terror, rising oil prices, and unfavorable trade balances. This method of expanding the money supply, via real estate related financial intermediaries, helped fuel continuing demand and thus speculation in housing markets.

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63. *See* Paul Beckett & John Hechinger, *"Subprime" Could Be Bad News for Banks – Riskier Loans, Now Prevalent in Industry, Show Problems*, WALL ST. J., Aug. 9, 2001, at C1; Carrick Mollenkamp, *Faulty Assumptions: In Home-Lending Push, Banks Misjudged Risk – HSBC Borrowers Fall Behind on Payments*, WALL ST. J., Feb. 8, 2007, at A1.

64. *See* MALLOY & SMITH, *supra* note 27, at 313-14 (increasing diversity of home ownership); Todd J. Zywicki & Joseph D. Adamson, *The Law and Economics of Subprime Lending*, 80 U. COLO. L. REV. 1, 21-23 (2009). *See also* Miriam Jordon, *Housing Boom Aided Minorities*, WALL ST. J., May 13, 2009, at A3. During the recent housing boom, minority home ownership rates increased at a faster rate than that for whites. *Id.* The gains added a lot to the diversity of ownership, but since the bust, homeownership rates have fallen much more steeply for minorities than for whites. *Id.* This is in part due to the fact that minority borrowers were much more likely to have a subprime mortgage than whites. *Id.*

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D. *The Importance of the Underlying Real Estate Transaction*

It is important to focus on the underlying real estate transaction in the primary market when considering the future of secondary mortgage market activity. The quality and reliability of the underlying transaction is directly linked to the value of the mortgaged-based securities in the secondary mortgage market, and thus regulatory reform is required in both markets. One market deals with the property itself, as represented in the deed and other closing documents, and the other market deals in the representations of the underlying transaction. An ability to create documentary representations of property and then to deal in both *the* property and its representations adds economic potential to the market.[65]

For example, by creating deeds, mortgages, and title records we permit property owners to convey an interest in land that can be recorded and used as collateral for borrowing money. Here, the deed is a paper representation of rights of ownership in the property and the mortgage represents a contingent claim of a creditor to proceed against the property,

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65. *See* MALLOY, MARKET CONTEXT, *supra* note 4, at 10, 82-84, 108-09; HERNANDO DESOTO, THE MYSTERY OF CAPITAL: WHY CAPITALISM TRIUMPHS IN THE WEST AND FAILS EVERYWHERE ELSE (2000).

> In the West, . . . every parcel of land, every building, every piece of equipment, or store of inventories is represented in a property document that is the visible sign of a vast hidden process that connects all these assets to the rest of the economy. Thanks to this representational process, assets can lead an invisible, parallel life alongside their material existence. They can be used as collateral for credit. The single most important source of funds for new businesses in the United States is a mortgage on the entrepreneur's house. These assets can also provide a link to the owner's credit history, an accountable address for collection of debts and taxes, the basis for the creation of reliable and universal public utilities, and a foundation for the creation of securities (like mortgage-backed bonds) that can then be rediscounted and sold in secondary markets. By this process the West injects life into assets and makes them generate capital.

DESOTO, *supra*, at 6.

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as represented by the deed, in the event of nonpayment on the debtor/property owner's promise to repay the loan. The mortgage simultaneously, when coupled with a promissory note, represents rights to cash flow in terms of the principle and interest to be paid back on the loan. All of these documents can be recorded in the public records so that the market for exchange expands to include people who are distant from the parties to the underlying transaction. With verifiable public records, distant creditors and potential future buyers can extend funds to people with the appropriate documentation of ownership without having personal knowledge of the property or the parties involved.[66] Moreover, an entirely new set of transactions can be developed with respect to representations in the form of mortgaged-backed securities. These securities represent rights in the cash flow generated by the underlying mortgages, which are themselves supported by the underlying documentation that represents an ownership claim to the property to which they make reference. Consequently, one observes a market in the land and market activity in the primary and secondary representations of the land. The secondary mortgage market is essentially a market in the representations of the representations of the value of the underlying land transaction.

It is important to recognize that the market activity in the documents is a derivative or induced market with respect to the underlying transactions in the land itself.[67] Thus, the documentary or induced transactions are not living in some binary and parallel universe with respect to the underlying transaction; these transactions are connected.

Two significant errors may arise from not appreciating the deep connection between the underlying real estate transaction and the market for mortgage-backed securities. First, one may erroneously assume that the market for mortgage-backed securities is independent of the underlying real estate transaction. This may then lead one to believe that the underlying transactions and the secondary market exchanges

66. *See* DESOTO, *supra* note 65, at 6.

67. *See* MALLOY, MARKET ECONOMY, *supra* note 4, at 83-85. *See also* ISRAEL M. KIRZNER, THE MEANING OF MARKET PROCESS 42 (1992).

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live parallel lives.[68] As a consequence, attention is focused on the securities market with little interest in looking back at the fundamentals of the underlying mortgage markets, and this is problematic because the quality of the underlying real estate transaction establishes the real value of the securities that are themselves representations of the underlying exchange. In short, people dealing with mortgage-backed securities may come to believe that property, itself, does not matter.

The second error occurs in thinking that the market values of the induced transactions (those transactions in the secondary market) are the same as those equilibrium values predetermined by the relevant values of the underlying real estate transactions.[69] In other words, the first error is compounded by believing that the value of the induced transaction is basically the same as the value of the underlying transaction such that one only needs to know the price of the mortgaged-back security to assume the value of the underlying real estate transaction. This is incorrect because the value of the underlying real estate transaction expresses a degree of freedom with respect to the price of the induced transaction, or stated differently, the value of the induced transaction is not fully determined by or covariant with the underlying transaction.[70] Consequently, buying and selling mortgage-related securities at a good price and high profit does not mean that the underlying real estate transactions are of similar good value, nor even that they are economically sound. In other words, the underlying real estate transaction should, but may not, reflect the requisite value attributable to it by the secondary market. Again, more attention needs to be paid to the quality and value of the underlying real estate transactions because they substantiate the expected market value of the induced transactions in the secondary mortgage market.

A third problem with current mortgage market approaches involves the devaluing and displacement of human judgment

68. See DESOTO, supra note 65, at 6 ("assets can lead an invisible, *parallel life* alongside the material existence") (emphasis added).

69. *See* MALLOY, MARKET ECONOMY, *supra* note 4, at 83-85. *See also* ISRAEL M. KIRZNER, THE MEANING OF MARKET PROCESS 42 (1992).

70. *See* MALLOY, MARKET ECONOMY, *supra* note 4, at 83-85. *See also* ISRAEL M. KIRZNER, THE MEANING OF MARKET PROCESS 42 (1992).

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and accountability in the loan origination process.[71] Human judgment has been replaced by mathematical models and standardized credit scores. While there are concerns about the potential for bias and unfair discrimination when using human judgment, this should not mean that every decision must turn on a mathematical calculation and the appearance of scientific objectivity.[72] The exercise of reasonable human judgment can facilitate the origination of potentially higher quality loans. Active involvement by lawyers, financial experts, and other advisors can also raise the qualitative aspects of the lending decision and its documentation. This is especially true when participants are held accountable for the quality of their advice and for the decisions that they make.

Currently, the underlying real estate transactions are dominated by sales people with inadequate knowledge of the law of property and real estate transactions.[73] Transactions are done on uniform documents that offer the pretence of completeness and are written in "simple English." This masks the fact that the legal consequences of the words in the documents are not apparent to the typical reader, even though the reader thinks the meaning is clear.[74] Since everything is on a pre-written form, there is little room for professional legal judgment on behalf of the client. And even though title examination and title insurance are supposed to be done on an individually reviewed basis, the practice, in spite of the regulation, is that everything is simply treated as a risk factor.[75] Instead of doing the work to examine and clean-up

71. *See generally* Cassandra Jones Havard, *Democratizing Credit: Examining the Structural Inequities of Subprime Lending*, 56 SYRACUSE L. REV. 233 (2006).

72. *See* MALLOY, MARKET ECONOMY, *supra* note 4, at 53-54.

73. *See generally* Lloyd T. Wilson, Jr., *Sometimes Less is More: Utility, Preemption, and Hermeneutical Criticisms of Proposed Federal Regulation of Mortgage Brokers*, 59 S.C. L. REV. 61 (2007).

74. *See* Lauren E. Willis, *Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending: Price*, 65 MD. L. REV. 707, 762-66 (2006).

75. Title insurance is meant to be issued based on an actual review of the property and of all the property related records, with a specific conclusion drawn as to the status of title for the specific piece of property. It is not meant to be a simple risk-based insurance coverage. *See* MALLOY & SMITH, *supra* note 27, at 269-91; Robin Paul Malloy & Mark Klapow, *Attorney Malpractice for Failure to Require Fee Owner's Title Insurance in a Residential Real Estate Transaction*, 74 ST. JOHN'S L. REV. 407, 427-28, 439-

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title problems the way it should be done, many insurers simply insure the risk of a potential transaction going bad.

In a similar way, lenders have changed the way they do business. Lenders now deal with uniform documents and numeric credit scores, use minimal or no back-up documentation, and retain little or no ownership interest in the loans they originate.[76] These lenders no longer function as simple intermediaries between savers and borrowers; they function as complex financial institutions offering a wide range of products and services. In this lending environment, the residential housing market is simply a paper-churning process engaged in to generate fee and service income with the vast majority of mortgages being sold into the secondary market. This new arrangement eliminates a great deal of human judgment with respect to the quality of the loan and the credit worthiness of the borrower.

In the current (pre-meltdown) environment of the secondary mortgage market, judgment and accountability have been traded for the "efficiency" of high volume and the making of risk contracts to cover losses—risk contracts that apparently failed to account for the low quality of the underlying real estate transaction.

IV. Fixing the Primary Market

From a primary market perspective, there are a number of steps that can be taken to improve the soundness of housing and mortgage markets as they impact secondary mortgage market operations. This section of the Article addresses three areas in which specific steps can be taken. These areas involve: taking steps to reduce speculation in housing prices;

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40 (2000). *See also* Robin Paul Malloy, *Using Title Insurance to Avoid Malpractice and Protect Clients in a Changing Marketplace*, 11 THE DIGEST 51, 55 (2003) (noting that 25% of real estate transactions involve a title problem).

76. *See* Brescia, *supra* note 49, at 289-90; Julia Patterson Forrester, *Fannie Mae/Freddie Mac Uniform Mortgage Instruments: The Forgotten Benefit to Homeowners*, 72 MO. L. REV. 1077, 1083-87 (2007); Schuster, *supra* note 49, at 155-58; Willis, *supra* note 74, at 715-721. *See generally* Peter M. Carrozzo, *Marketing the American Mortgage: The Emergency Home Finance Act of 1970, Standardization and the Secondary Market Revolution*, 39 REAL PROP. PROB. & TR. J. 765 (2005).

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reducing incentives to over-borrow and over-lend; and dealing with an inverse prisoner's dilemma problem by re-professionalizing the underlying real estate transaction.

A. *Curbing Housing Market Speculation*

When one examines the problems driving the crisis in mortgage markets and mortgage-backed securities, it is difficult to underestimate the role of housing market speculation. Speculation as to the never-ending rise in future home values was the foundation for numerous investment missteps.[77] Borrowers were convinced that they could afford more house than they could pay for and that they could take on all kinds of debt, including "toxic loans" with negative amortization and exploding interest rates, because the future rise in value of the property would more than cover any present disparity in ability to pay.[78] Lenders also let their guards down, feeling that future increases in housing prices would cover any risk not otherwise spread and passed off through the secondary mortgage market.[79] Mortgage brokers and originators took advantage of the situation to put people into bigger loans and earn higher dollar payout commissions.[80]

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77. Speculation and market bubbles have been problems for centuries. *See generally, e.g.*, Christian C. Day, *Paper Conspiracies and the End of All Good Order: Perceptions and Speculation in Early Capital Markets*, 1 ENTREPRENEURIAL BUS. L.J. 283 (2006).

78. *See* Kirstin Downey, *Non-Traditional Loans Require Financial Discipline*, WASH. POST, Mar. 25, 2006, at F10; Kenneth R. Harney, *Those Interest-Only Loans May Turn Toxic for Some*, CHI. TRIB., July 4, 2004, at 2.

79. *See generally* Georgette C. Poindexter, *Subordinated Rolling Equity: Analyzing Real Estate Loan Default in the Era of Securitization*, 50 EMORY L.J. 519 (2001).

80. For example, a borrower might qualify for a $300,000 conventional mortgage yet be strongly encouraged to apply for a $500,000 subprime loan. The idea or sales pitch behind this is that the buyer will get ownership of a higher valued property with the larger loan and gain from greater leverage and control of a more valuable asset. If one assumes (as a speculator) that market prices for the property will rise at a fast rate, then more is to be gained by using more leverage, and the rapidly rising equity will more than cover getting the buyer out from the burden of a subprime loan with profit on a sale or a refinance in relatively short order. Of course, the key here is that prices have to keep rising as fast as or faster than assumed. In any event, the loan originator pockets a higher commission based on the percent applied to the larger loan. After closing the deal the failure of any expectations as to future prices falls on the borrower, not the loan originator.

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In evaluating the role of speculation and overly optimistic speculation of future housing prices, I start from the view that the basic residential housing policy in America is about securing a reasonable opportunity for homeownership for as realistically large a percentage of the population as possible. In stating this I recognize two things. First, not everyone in America will be able to enjoy the same type of housing ownership because fee ownership of single family housing is expensive. This means that we have to simultaneously work harder to create more varieties of home ownership and improved leasehold tenure. And second, it also means that the implicit goal of the American housing policy is and has been about home ownership and not property speculation.

One of the underlying problems leading up to the meltdown in home mortgage markets has been due to the inherent tension of inconsistent government policies; one policy seeks to make housing affordable and accessible with a vast network of direct and indirect government support systems, while the other facilitates speculation and get-rich-quick schemes from the very same housing products.[81] These two goals are inherently inconsistent. Residential housing is supported by a vast array of public funding because we want people to have an ownership interest in the places where they live, not because we want to make them venture capitalists. Supporting homeownership with public dollars requires a stable program whereas promoting homeownership as a primary source of wealth accumulation fosters speculation and risk.

A key step that can be taken to reduce speculation and undermine the incentive to flip properties is one of eliminating gains from equity appreciation in the early years of home ownership.[82] This can be done by taxing away the realization of equity appreciation gains from a sale during a stated time

81. For a discussion of federal housing policy, see Emerson, *supra* note 35, at 421-30; and Forrester, *supra* note 35, at 393-419.

82. One problem is "flipping," where a house is purchased and then resold in a very short period of time in order to gain from speculation or from pumping up an appraisal. One way to reduce the incentive for this kind of speculative activity is to put a significant tax on the realization of equity appreciation when and if the property is sold within a designated period. No tax is due in the absence of a triggering event, such as a sale or refinance, within the regulated time period.

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period. In order to make the equity appreciation tax more viable from a constitutional perspective it should probably be a step down tax so that the tax rate decreases at the end of each year of ownership. Thus, one might tax any equity appreciation for the first five years of ownership with step down rates like: 95% in year 1; 80% in year 2; 70% in year 3; 45% in year 4; 20% in year 5; and 0% thereafter. Vermont is a state with such a program in place to reduce speculation, and challenges to it have been unsuccessful, as the state's courts have held that the law is constitutional and supported by a rational public purpose.[83] The main point here, however, is not to endorse any particular approach, such as the Vermont tax, but rather to develop some kind of a tax that reduces speculation.

The main justification for this is that the public, through indirect government subsidy of the credit and mortgage markets, subsidizes residential housing; it is thus fair and reasonable for government to manage equity speculation. This management would be focused on the early years of home ownership and any limitations on gain would be offset by the potential for greater stability and predictability in the longer-run mortgage markets. This kind of equity accumulation constraint is nothing more than what we often demand of low-income buyers who rely on a variety of direct subsidy programs to acquire so-called affordable homeownership.[84] There is no

83. *See generally, e.g.*, VT. STAT. ANN. tit. 32 §§10001-10007 (2009); Andrews v. Lathrop, 315 A.2d. 860 (Vt. 1974); Karl E. Case, *Taxes and Speculative Behavior in Land and Real Estate Markets*, *in* 4 REV. URB. & REGIONAL DEV. STUD. 226 (pt. 2) (July 1992); Thomas L. Daniels et al., *The Vermont Land Gains Tax: Experience With It Provides a Useful Lesson in the Design of Modern Land Policy*, 45 AM. J. ECON. & SOC. 441 (1986); Dennis Robinson & Elizabeth M. Chant, *Interaction of Land Policy and Land-Based Tax Policy: The Vermont Land Gains Tax*, *in* 4 REV. URB. & REGIONAL STUD. 147 (pt. 2) (July 1992); *A Special Report on Vermont Real Estate Taxes*, VT. PROP. OWNERS REP. (Vermont Real Estate Today, Montpelier, VT.) (Supp.), Sept. 2006.

84. Here, I simply point out that we already have housing programs that constrain or restrict one's claim to future equity appreciation. Given this, it should not be considered alien to suggest that such constraints or restrictions apply to other and broader categories of residential housing. For an example of the kind of general restriction on housing equity that I am referring to, see generally AFFORDABLE HOUSING AND PUBLIC-PRIVATE PARTNERSHIPS, *supra* note 25; JOHN EMMEUS DAVIS, NAT'L HOUS. INST., SHARED EQUITY HOME OWNERSHIP: THE CHANGING LANDSCAPE OF RE-SALE RESTRICTED, OWNER-

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apparent reason to treat low-income borrowers receiving direct subsidies any different than higher-income debtors privileged by indirect subsidies.

Such an equity appreciation tax would be similar in its goal to that of a Tobin tax.[85] Each attempts to reduce short-term speculation while retaining long-term benefits of exchange. The Tobin tax deals with speculation in cross country currency trades, whereas the equity appreciation tax seeks to reduce the incentive for quick and speculative trades in housing markets.[86] There would be no incentive for housing flips (often done within a short-time of the original transaction) if there is no immediate equity gain to be realized. This not only cools down speculation and a major rationale for over-borrowing and over-lending, but it also undermines one of the biggest elements of fraud in the housing market.

Importantly, such a tax does not take away or diminish the value of the property; the tax only goes to equity appreciation over the stated period of time, and it is triggered only by an event such as a resale within the stated time period. If a buyer paid a fair market price, he should be able to get that back even if he sells during the first five years. The main point is that we should encourage home ownership and stability in communities while undermining the incentives for speculation and fraud in housing and mortgage markets.

Other steps could be taken to supplement this anti-speculation idea. These can include elimination of the tax benefits for interest deductions on home mortgages, or to at

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OCCUPIED HOUSING (2006); EMILY THANDEN, VANDERBILT UNIV. CMTY. RESEARCH & ACTION PROGRAM, SHARED EQUITY HOMEOWNERSHIP: SHARING THE COSTS & BENEFITS (2008), *available at* http://www.thda.org/govsummit/presentations/Shared%20Equity%20Homeownership%20Sharing%20the%20Costs%20Benefits.pdf; and Thomas J. Miceli et al., *The Role of Limited-Equity Cooperatives in Providing Affordable Housing*, 5 HOUSING POL'Y DEBATE 469 (1994).

85. For a quick explanation of the Tobin tax, which taxes away quick gains on currency speculation, see TOBIN TAX INITIATIVE, FACT SHEET ON TOBIN TAXES, http://www.ceedweb.org/iirp/factsheet.htm (last visited Oct. 16, 2009). *See also generally* Thomas I. Palley, *Speculation and Tobin Taxes: Why Sand in the Wheels Can Increase Economic Efficiency*, 69 J. Econ. 113 (1999) (Austria).

86. *See* TOBIN TAX INITIATIVE, *supra* note 85. *See also generally* Palley, *supra* note 85.

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least suspend it for the first several years of ownership.[87] The deduction is not needed as we can observe similar homeownership rates in countries such as Canada where there is no special tax benefit for mortgage interest payments.[88] The actual result of the mortgage interest deduction is that it encourages wealthier Americans to buy bigger homes than needed in order to get a tax shelter. This is bad in itself since it encourages over use of resources and promotes bigger and increasingly more negative impacts on the environment than would otherwise be demanded by housing consumers.

B. *Reducing the Incentive to Over-Borrow and Over-Lend*

There are a number of steps that might be taken to reduce the incentives for bad loans in the primary market. In this section of the Article, I consider two areas where effective action can be taken. These areas deal with the commission structure for loan origination and the transferring of accountability in the selling of loans to the secondary market.

In the primary market, buyers of property frequently need or opt for mortgage financing. In seeking a mortgage, they generally deal with an originating mortgage broker or with a loan officer at a lending institution. These loan originators typically work on some combination of salary and commission with commission incentives weighing heavily as the key incentive for compensation. Working for points as a percentage of the loan amount, the loan originators have an incentive to qualify borrowers and to push them into larger loans.[89] For example, if the originator earns 2% on each new loan origination, she can double her return by getting a borrower to take a more risky loan of $300,000 rather than a $150,000 loan

87. *See* INTERNAL REVENUE SERV., HOME MORTGAGE INTEREST DEDUCTION, PUBLICATION 936 (2009), *available at* http://www.irs.gov/pub/irs-pdf/p936.pdf.

88. Homeownership rates are similar in the United States and Canada, even though Canada does not allow a tax break for mortgage interest deductions and it requires a 20% down payment, or else mortgage insurance must be acquired. *See* Marie-Josee Kravis, *Regulation Didn't Save Canada's Banks*, WALL ST. J., MAY 7, 2009, at A17; Mann, *supra* note 35, at 1385-86; CAN. MORTGAGE & HOUS. CORP., HOMEOWNERSHIP MARKET, http://www.cmhc-schl.gc.ca/en/corp/about/cahoob/data/data_003.cfm (last visited Oct. 16, 2009).

89. *See generally* Brescia, *supra* note 49; Havard, *supra* note 71.

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that is more readily affordable. This accounts in part for the fact that some 35% of subprime loans went to people who could have purchased a home on a mortgage they could afford but instead opted for a much larger loan on subprime terms.

This push for moving borrowers to loans with larger dollar amounts is also incentivized by the fact that it cost about the same amount in terms of time and paperwork to process a small loan as it does a larger loan. Therefore, to produce favorable economies of scale, effort is expended toward originating large loans rather than small ones, again incentivizing the pushing of borrowers into riskier debt positions. One way to reduce this perverse incentive structure is to eliminate commissions on loan origination. Since the work and time required on all of these home loans is similar, all originations should be done on a flat fee basis—perhaps a few hundred dollars per loan without regard to the loan amount.[90]

A related problem arises from the tax code and the way it incentivizes over-borrowing by rewarding debtors for taking on larger loans to produce higher tax benefits.[91] The incentive structure works to encourage the purchase of larger and more expensive homes. The irony, of course, is that to the extent that housing markets are efficient, the future tax benefit will be discounted and built into the present value pricing of the home. This means that housing is more expensive than it otherwise would be since home buyers have to pay now for the future stream of tax benefits, and this arrangement favors the middle and upper class while making initial homeownership that much more difficult for people with lower incomes. It is a straight-out subsidy for the middle and upper classes with little evidence that it substantially helps expand home ownership rates, in spite of the assertions of real estate salespeople.

A second area of concern involves lender accountability. Here I have two key suggestions. Each suggestion goes to the matter of keeping loan originating institutions accountable for

90. *See* MALLOY, MARKET ECONOMY, *supra* note 4, at 53-55.

91. *See supra* notes 87-88 and accompanying text. The IRS mortgage interest tax deduction is an incentive to borrow more in order to get a higher offsetting deduction from a bigger loan.

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the loans that they originate. One suggestion deals with recourse liability on the loans that are sold to the secondary market, and the second deals with the elimination of the deficiency judgment in the event of a default and foreclosure against a borrower with little or no equity in the transaction.[92]

A problem fostered by the secondary mortgage market is the reduction in accountability of primary lenders when they sell mortgages to the secondary market. The lack of a continuing ownership interest and direct responsibility for loan risk reduces long-term accountability for making bad lending decisions. When lenders hold the mortgages they originate, they have a stronger interest in making sure the loans are well supported in the first instance. One way to bring back greater accountability is to require lenders to retain an ownership interest in their loans even after they are sold, or to make all such loan sales recourse. Making all such sales recourse would be different from requiring the lender to keep an ownership interest but it would still add to accountability because all bad loans and debt would remain a contingent liability of the originating lender.

Related to this approach is to eliminate a lender's right to a deficiency judgment against a defaulting borrower.[93] Currently most state laws dealing with foreclosure permit a lender to sue a defaulting borrower for any deficiency between the amount owed on the mortgage loan and the amount that the property brings in at a foreclosure sale.[94] One way to make the lender more cautious about the quality of the loan in the first instance is to eliminate the right to seek a deficiency judgment in the event of default and foreclosure. This would make the lender look entirely to the land for recovery of the

92. *See, e.g.*, Lawrence D. Jones, *Deficiency Judgments and the Exercise of the Default Option in Home Mortgage Loans*, 36 J. L. & ECON. 115, 135 (1993); Todd J. Sywicki & Joseph D. Adamson, *The Law and Economics of Subprime Lending*, 80 U. COLO. L. REV. 1, 30-35, 41-45 (2009). *See also* MALLOY & SMITH, *supra* note 27, at 447-77 (discussing foreclosure). *See generally* John Mixon, *Fannie Mae/Freddie Mac Home Mortgage Documents Interpreted as Nonrecourse Debt (with Poetic Comments Lifted from Carl Sandburg)*, 45 CAL. W. L. REV. 35 (2008).

93. *See* MALLOY & SMITH, *supra* note 27, at 447-77 (discussing foreclosure). *See generally* NELSON & WHITMAN, *supra* note 28 (same).

94. *See* MALLOY & SMITH, *supra* note 27, at 447-77 (discussing foreclosure). *See generally* NELSON & WHITMAN, *supra* note 28 (same).

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debt in the event of default. Therefore, lenders would have increased incentives to get fair and honest appraisals of the properties when making loan decisions.

This limitation on deficiency judgments could be structured in one of two ways: it could be an across-the-board elimination of this remedy, or it could be applied to particular loan standards. As to particular loan standards, it might be that a rule would state that the right to a deficiency judgment is limited to loans in which the borrower had at least a 20% equity interest in the property at the time of the mortgage. This would include the elimination of "piggy back" mortgages where lenders "pretend" that a borrower has 20% equity by making two simultaneous loans; one for 80% as a first mortgage and one for 20% as a second loan.[95] This two-step process has been used to get around the need for private mortgage insurance (PMI) by papering a file to look like there is 20% equity when in fact 100% of the property value is mortgaged.[96]

Similarly, deficiency judgments could be eliminated in situations where a lender chose to use a high risk or complex mortgage loan form, such as one with negative amortization, open-ended (no cap) adjustable interest rates, or one based on so-called low documentation. Another alternative would be to simply exclude such loans from the secondary market and require originating lenders to hold them in their own loan portfolios.

C. *Addressing an Inverse Prisoner's Dilemma Problem in the Underlying Real Estate Transaction*

Correcting the secondary mortgage market requires that we also attend to problems manifesting themselves in the

95. *See* Sywicki & Adamson, *supra* note 92, at 41-43; Edmund L. Andrews, *Most Homeowners Not Overly in Debt, Fed Chief Says*, N.Y. TIMES, Sept. 27, 2005, at C1.

96. *See* MALLOY & SMITH, *supra* note 27, at 399 (discussing piggyback mortgages). *See also* Simon, *supra* note 61 (stating that "[t]he share of borrowers with prime jumbo loans who took out a 'piggyback' second mortgage – which allowed borrowers to finance more than 80% of their home's value without private mortgage insurance – climbed to a record 33% in 2007").

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primary market, at the intersection of the underlying real estate transaction and the loan origination process. One source of problems here is related to what I think of as an inverse prisoner's dilemma problem. In the standard prisoner's dilemma we confront a situation in which transacting parties confront various transaction costs which drive them to take non-cooperative positions resulting in inefficiencies, and these inefficiencies generate less than optimal social benefits.[97] In the standard analysis of the prisoner's dilemma, efforts are undertaken to use law to reduce the interfering transaction costs so that the transacting parties will cooperate and negotiate to an efficient exchange relationship. In the current (pre-meltdown) environment a number of problems can be better understood by thinking in terms of an inverse prisoner's dilemma.[98] To a significant degree, the problem in the primary mortgage market is one of cooperation rather than failure to cooperate. The incentive structure of the underlying transaction favors cooperation in misbehavior and fraud.[99] In papering fraudulent transactions with hyped up appraisals, bad surveys, and simultaneous flips, it takes more than one participant to succeed.[100] The underlying transactions have

97. *See* MALLOY, MARKET ECONOMY, *supra* note 4, at 130-32 (discussing the prisoner's dilemma). *See generally* McAdams, *supra* note 5.

98. *See* MALLOY, MARKET ECONOMY, *supra* note 4, at 130-32 (discussing the prisoner's dilemma). *See generally* McAdams, *supra* note 5.

99. *See generally* Brescia, *supra* note 49, at 292; Gretchen Morgenson, *Inside the Countrywide Lending Spree*, N.Y. TIMES, Aug. 26, 2007, at 3.1; Bob Tedeschi, *Report Piles Blame on Brokers*, N.Y. TIMES, Apr. 20, 2008, at RE10; Julie Creswell & Vikas Bajaj, *A Mortgage Crisis Begins to Spiral, and the Causalities Mount,* N.Y. TIMES, Mar. 5, 2007, at C1; Kathleen Day, *Villains in the Mortgage Mess? Start at Wall Street. Keep Going*, WASH. POST, June 1, 2008, at B1.

100. *See, e.g.*, Michael M. Phillips, *Would You Pay $103,000 for This Arizona Fixer-Upper? – That Was Ms. Halterman's Mortgage on It*, WALL ST. J., Jan. 3, 2009, at A1. The article chronicles the financing of a property valued at $15,000 for $103,000 to a woman who had been without a job for 13 years and whose only source of income was welfare and food stamps. *Id*. For a fee of $350 an appraiser valued the house at $132,000 without ever looking at it. *Id*. The house was condemned with a notice stapled to the wall, stating that it was "unfit for human occupation." *Id*. The mortgage was originated by a small mortgage firm named Integrity (a firm located in Arizona), and it collected $6,153 in fees for the origination. *Id.* The loan was sold to Wells Fargo and then to the London-based HSBC. *Id.* The mortgage was then bundled with 4,050 other mortgages and used as collateral for a security issued in July, 2007. *Id.*

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basically become degraded and corrupt, and there is a need for legal action to reduce the incentive to cooperate among the misbehaving participants.

In this section of the Article I focus on the underlying real estate transaction and suggest ways to reduce the incentive to cooperate in degraded transactions by changing the existing exchange relationships.

There are several steps to be taken to improve the quality of the underlying real estate transaction which is important to also improve the quality of the securities issued in the secondary mortgage market. These include "right fitting" the professional expertise needed to properly structure and close a real estate transaction, making the work and fees for services more transparent and providing incentives for participants in the underlying transaction to report misbehavior and fraud.

In a typical real estate transaction involving residential housing, there are three primary elements; one involves the selling of the house as a consumer good, a second involves the transfer and conveyance of all of the relevant property interests, and the third involves the legal arrangements for structured mortgage financing. Two of these areas require the expertise and knowledge of a professional licensed attorney; one requires the skill of a professional real estate salesperson.

The process of selling a house as a consumer good is one that is best handled by a real estate salesperson: marketing issues must be attended to and knowledge of current consumer tastes and preferences is needed. The salesperson develops a strategy for highlighting the important features of the house and establishes a plan for connecting potential buyers with hopeful sellers. This is an important intermediary function.

In the American housing market the problem is that real estate salespeople have been allowed to function in areas in which they are not fully qualified. The important tasks of drafting a purchase and sale contract and of understanding the details of conveyancing and title are beyond the realm of a salesperson's expertise.[101] While most salespeople believe they

101. There is, after all, a reason that people go to law school and get licensed to understand the legal aspects of property law, foreclosure law, and real estate transactions. Non-lawyers do not fully appreciate the legal implications of these transactions. Policy in this area seems to be shaped by a simple desire to reduce transaction costs by dramatically reducing and even

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know property law and the law of real estate transactions, this belief is simply unfounded. The skill set and knowledge of real estate sales has little to do with understanding the details and nuances of property and mortgage law. Salespeople also step outside of their area of expertise in addressing the structuring of mortgage financing. Some salespeople understand the economic implications of particular financing arrangements but lack knowledge of the legal and property implications of mortgage law, including the law of default and foreclosure, which must be assessed up front when advising borrowers. More importantly, salespeople lack the professional licensing of a lawyer that provides consumers with important information about the individual's training and knowledge, and which makes the individual liable for a particular standard of care and conduct as governed under the law and by the Rules of Professional Responsibility.

As to the inverse prisoner's dilemma problem, the real estate salesperson and the loan originator often function as gatekeepers for coordinating ancillary services provided by such parties as appraisers, surveyors, and title insurers. Today many salespeople not only prepare the purchase and sales contract but also connect the buyer to a loan originator and the other ancillary service providers. In this role as gatekeeper, the salesperson, like the loan originator, is driven by making a sale and earning a commission. Even when good intentions are in play, the incentive structure works to facilitate cooperation in a sense that is not always positive. Appraisers, title companies, and surveyors know that their business is contingent upon cooperation with the gatekeepers who deal in volume. Being cut out of the transaction because one is perceived as being difficult to work with, too cautious, a "deal killer" by slowing up the deal, or for following practice guidelines that cost more than the services others will provide, means the end of a profitable business relationship. Many business players in the residential market depend on referrals and inclusion by the gatekeepers in order to make a living. Competition that is not properly policed and regulated,

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eliminating lawyers from a meaningful role in the exchange. This has been done without careful consideration of the consequences, such as the continuing degradation of primary market transactions.

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therefore, often results in an incentive to cut corners and go along so that everyone makes money, even if the deal is degraded and unsound.

One of the key underlying problems, of course, involves asymmetrical information.[102] The borrowers in these transactions have inferior information and typically less knowledge than the parties who are regular participants in the networks of primary and secondary mortgage market financing. Consequently, the consumer is in no real position to police or even fully understand the weaknesses of the system in which she is operating. This weakness is not corrected by government requirements for pages of disclosure information, which most people do not really bother to read or understand, especially since salespeople generally are willing to offer a watered down assurance of everything as being just fine. It is difficult and perhaps even economically irrational for consumers to spend their time and effort actually overcoming the asymmetrical information problem such that we cannot rely on consumers to correct the market on their own; public regulation is required. Moreover, the idea that the buying, selling, and financing of property in the United States is dominated by salespeople with no professional qualifications in law is difficult to believe, and it fosters exchange relationships that create mutual incentives for degraded cooperation—cooperation that, unless heavily policed and regulated, leads to potentially toxic externality costs for mortgage and financial markets.

To a large extent the legal profession in the United States is at fault here for its willingness to continuously erode its professional duty in the area of real estate transactions.[103] Gradually the courts have granted more and more authority to non-lawyers to operate in areas of property law—areas in which non-lawyers are not properly trained, educated, or

102. *See* MALLOY, MARKET CONTEXT, *supra* note 4, at 169-72 (discussing asymmetrical information).

103. The profession has ceded ground to non-lawyers in the basic real estate transaction, and lawyers have become meaningless participants when used because gatekeepers have worked to keep lawyer compensation so low that almost no lawyer can actually afford to spend the time doing competent legal work on the file. Exceptions would be when a lawyer represents a high-income buyer of a very expensive home, where the buyer understands the complexity, and is willing to pay.

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regulated. My recommendations here are that sales professionals should confine their work to sales and all contract drafting, title evaluation, mortgage advising and closing of real estate transactions must be done by licensed real estate lawyers. In order to make this a reality, there must be a return to earlier requirements as to the definition of the practice of law, with strong prosecution of the unauthorized practice of law.

Returning lawyers to the transaction will beneficially alter the exchange relationship of the transaction. Lawyers are not salespeople and they have expertise in the underlying subject matter of the sale and the mortgage financing. More importantly, they are advocates who understand the transactional benefits of an adversarial process. They understand that some transaction costs generate positive social externalities.[104] The attorney does not work on a commission, does not rely on the closing of the transaction to earn a fee, and is held to a professional code of conduct that reduces the incentive for participation in transactional misbehavior. If all parties are represented by attorneys at the closing, a rare situation in today's marketplace, there is likely to be a much higher quality transaction and thus a higher quality basis for the derivative transactions in the mortgage-backed securities markets. In this context, legislation and professional regulations need to prohibit real estate people from engaging in activities that go beyond sales work, and the meaning of sales work should go back to earlier definitions when sales people were not permitted to complete contracts, fill in legal forms, or provide mortgage advice. In addition, lawyers and salespeople should be prohibited from representing more than one party to a transaction and from splitting or sharing fees and commissions.

Naturally, in order to effectively bring lawyers back into the residential transaction to perform a substantive and purposeful role rather than a perfunctory one, the transactions have to make economic sense. It is here that we need a change in belief and understanding on the part of the general public.

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104. *See* David M. Driesen & Shubha Ghosh, *The Functions of Transaction Costs: Rethinking Transaction Cost Minimization in a World of Friction*, 47 ARIZ. L. REV. 61, 109 (2005).

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It is ridiculous for salespeople to be collecting $7,000, $10,000, or more, in commissions at a closing while buyers, sellers, and lenders cringe at the thought of paying a lawyer $200. The public has been fooled into thinking that salespeople can do the job of a lawyer and that there is nothing to be gained from compensating a lawyer for active participation in the full scope of the exchange. Lawyers need to get back to playing a central role in these transactions and they have to make a living wage from doing this work if it is to have any substantive value.

Admittedly not every lawyer is an expert in real estate just because he or she has a law degree. Therefore, law schools and the Bar should develop a specialized area of practice in real estate conveyancing, with a special certification and requirements for annual education updates. These specialized lawyers would handle all residential real estate transactions and be subject to certification and periodic evaluation and review. They would need to be well-qualified in such subjects as contract, property, and mortgage law, including foreclosure, and appropriate federal housing regulations. In addition, they would need to know title examination, title insurance, condominium and common property ownership law, negotiable instruments, electronic fund transfers, secured transactions, local land use and zoning law, implications for bankruptcy, and they would need to have basic knowledge of surveys and appraisals. Only certified conveyancing lawyers would be allowed to handle residential transactions involving funds drawn on, and mortgages funded by federally chartered or insured institutions, or any institution that sells mortgage-related instruments into the secondary markets. States could, of course, further regulate this practice with respect to funds drawn from, or mortgages made by, state institutions and with private funding. Commercial real estate transactions would be excluded from these specific regulations for the time being.[105]

In terms of compensation, lawyers and salespeople should each charge for services on an hourly basis and prepare a detailed statement supporting the bill. This would provide more information and make the process more transparent.

105. The concerns in a commercial real estate transaction are different. In these transactions, lawyers are still significant participants and the clients are typically much better informed than those in the residential home market. There is also less of a problem with asymmetrical information.

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Percentage commissions make no sense because they often bear no relationship to the work performed, provide no detailed billing information as to service performed, and encourage pushing buyers into bigger and more expensive homes and mortgages. Percentage billing on real estate sales commissions simply facilitates the kind of problems we see elsewhere in the primary market for real estate transactions and finance.

In addition, there should be an incentive structure to encourage participants in a transaction to report misbehavior and fraud to the proper law enforcement authorities. For example, a person reporting the use of hyped appraisals or questionable and simultaneous flips might be rewarded with triple the amount of the closing costs plus attorney fees and costs. This, or something like it, would help break the degraded cooperation that has undermined the soundness of the mortgage markets. We might also require that residential housing loans be funded by specially charted and registered financial institutions doing nothing but residential mortgages.

Making these changes may increase the cost of closing a given transaction, but then it may save much more than it costs by dramatically improving market outcomes. In other words, increased costs on the individual underlying transactions can nonetheless generate positive externalities for society that far exceed the costs.[106] Avoiding the hundreds of billions of dollars in catastrophic losses that we are now experiencing would be worth slight increases in the cost of performing the underlying transactions.[107] There are a number of values and factors to consider in comparing overall costs and benefits at the individual micro level and the broader macro level. People just need to face up to the fact that there are expenses and transaction costs that accompany buying and owning a home. These include paying reasonable attorney fees and confronting a given set of transaction costs that lead to positive social benefits for the entire system.

If we are worried about rising transaction costs and we want to assist people in buying a first home, we should avoid subsidizing them in ways that push them into economically

106. *See* Driesen & Ghosh, *supra* note 104, at 109.

107. Worldwide losses on bad loans and securitization are estimated to be $4.1 trillion. *See* Maurer & Linblad, *supra* note 22.

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unsound mortgage relationships and that unnecessarily degrade the mortgage market. It is better to get them into mortgages where they can afford the monthly payments and subsidize them in terms of the closing cost of getting into a first home. There can be multiple ways of doing this and here I suggest one way. We can establish a program that provides qualifying first-time home buyers with an earned income credit for closing costs directly related to professional services up to $5,000.[108] This earned income credit would apply to professional services billed on an hourly rate with an itemized receipt and could include attorney fees, real estate sales and broker fees (if the service is fully billed on an itemized hourly basis without commission and then coverable up to $1,500), title examination, and survey fees. Eligible buyers would be first-time home buyers earning up to 110% of the median income in the standard metropolitan statistical area in which the home is located. A program such as this would assist people with the difficult task of saving enough money to cover the closing costs, and thus make it easier to move from renting to ownership while still focusing on sound fundamentals in evaluating the willingness and ability to pay the debt service on the actual mortgage.[109]

V. Conclusion

The current financial crisis is a complex one with many causes. Many of the problems observed in the secondary mortgage market can be traced back to weaknesses in the underlying real estate transaction and the exchange relationships in the primary market. Therefore, as we think about the future of financial regulation and mortgage markets we must look carefully at the underlying exchange. The

108. An earned income tax credit provides a direct benefit to the taxpayer in the amount earned. The amount can be determined based on a number of factors; I suggest $5,000 as a reasonable starting point to offset closing costs for the first-time homebuyer, to the extent that these costs might increase by returning lawyers back to a role of substantive participation in the underlying real estate transaction. The suggested dollar amount is not the critical point; rather, it is the idea of using this kind of mechanism to assist people with the cost of getting into their first home.

109. *See* MALLOY & SMITH, *supra* note 27, at 368.

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quality of the primary market transaction drives the potential results that we can expect in the secondary market. With low quality going into the system, we will certainly get low quality coming out. Thus, planning for the future of financial regulation must include planning for the underlying real estate transaction.

As suggested in this Article, there are several steps that can and should be taken to improve the quality of the primary market in real estate transactions. First and foremost, we must come to realize the fallacy of the asserted ideology of self-correcting markets. Instead of waiting for under-regulated markets to correct themselves, we must develop volitional and purposeful regulation of housing and mortgage markets. We also need to take steps to curb speculation in housing prices, reduce incentives for over-borrowing and over-lending, and restructure the underlying exchange relationships to avoid the problems of an inverse prisoner's dilemma. Taking such steps may cause a rise in the closing expenses in the underlying real estate transaction but overall social benefits will increase as more certainty and stability govern the markets and as fewer incentives exist to promote people to over-borrow or to participate in fraud.

The fact is that buying and owning a home are expensive. Not everyone can afford the same type of home ownership. We need to fix the broken parts of our current market and we need to develop more and better types of housing opportunities that provide a sense of ownership and the benefits that go with it. Simply trying to put people into homes that they cannot afford does no one any good.

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